



**MICHAEL J. MURPHY**  
*State Treasurer*

# The QUARTERLY

Local Government Investment Pool

First Quarter 2006

## Fed watch: A pause and a hike?

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Talks of an early “pause” were just a speculation as the Federal Open Market Committee (FOMC) decided to raise its federal funds rate by another 25 basis points to 5.00 percent at its May 10 meeting. The committee said, that “... possible increase in resource utilization, in combination with the elevated prices of energy and other commodities, have the potential to add inflation pressures.”

This statement seems to pave the way for another rate hike in June.

Economic forecasters have revised their targets for the year after the recent FOMC statements. Consensus fed funds rate estimates have gone up to between 5.00- 5.50 percent. The reasons cited were more on stronger economic readings and inflation fears as oil prices have gone up again to record an all-time high of \$73.00/barrel. There were talks about the recent slowdown in the US housing market that could actually stunt future economic activities but this remains as conjecture from latest housing data. The key determinants to future interest rate paths are US macroeconomic conditions and commodity-price dynamics that could increase the risk of higher inflation numbers. The Federal Reserve will gauge the economy's need for further rate tightening based on the economic data. This has been their only stance when Fed Chairman Ben Bernanke took Mr. Greenspan's position.

The Fed minutes did shed some light as

some committee members expressed concerns about the possibility of tightening more than needed if the economic data suggest a slowdown. The lag effects of monetary tightening in an economic cycle could greatly influence the Fed's move after a 5.00 percent fed funds rate. The text mentioned that “most members thought the end of the tightening process was likely to be near “which makes economic data even more important in the future. But they also qualified their statement that “the need for further policy firming would be determined by the implications of incoming information for future activity and inflation.”

### Will there be a pause?

The Fed needs evidence before investors could see a pause or even see a change in their language. The first CY quarter of 2006 does not seem to have a message that might convince Chairman Bernanke. The broad-based job creation and evidence of tightening labor conditions have created a barrage of “Fed speak” about how the economy is just doing splendidly. St. Louis Fed President William Poole, just recently, even suggested that a 5.25 percent fed funds is “perfectly reasonable” given current economic conditions.

The FOMC committee members seem to reach a consensus that economic growth has been consistent and infla-

*continued on page 2*

## Market summary

*from page 1*

tion has been contained but worrisome. They have also elevated their concern about the rise in commodity prices. Last year, concerns were concentrated on energy prices. However, these concerns have spread out to include commodities like gold, copper, and other basic materials. The lagged effect of this phenomenon has affected the economy's core CPI figure outside the 1-2.00 percent band that the Fed is comfortable.

The Fed suggested that 'capacity utilization' still has room to pick-up slack without increasing inflation pressures. Nonetheless, this does not mean that everything is fine since there is still "inflation pressure" that could trigger the Fed's alarm button. Employment and output gaps are factors that could change the Fed's policy action. However, it is difficult for the Fed to look at these lagging indicators when commodity-price action suggests otherwise.

There are some sectors of the economy that have shown weakness in light of the Fed's interest hikes. The housing sector, as mentioned above, has shown substantial slowdown in economic activity. Sellers have been willing to slash prices in hot markets like Florida, Arizona and Nevada. Mortgage rates at 6.50 percent will provide a disincentive to the aggregate demand picture in the housing market.

Likewise, the consumer sector has also taken a hit with retail spending showing moderation from the weather-related surge in spending at the start of the year. A few more economic data like these could make investors reconsider their thoughts about a pause from the Fed. Fed governor Donald Kohn has said, "The economy is in transition to a sustainable pace of growth, in which case policy likely will be in transition as well."

## US Rates Review and Outlook

The yield curve has recently manifested an inversion after inflation-fears have circulated around global markets. However, the shorter-end of the curve took the brunt of the curve's re-pricing with 2s at 5.10 percent at the time of this writing. The ten-year notes have risen above the 5.06 percent for the first time this year. Likewise, the 30-year long bond has also experienced higher yield levels around the 5.09 area. The current price action signifies a market pricing in a 5.25 fed funds rate in June with near-certainty.

The Fed needs to assuage investors' fear that they are not behind the inflation curve in order for the market to gain its composure. The June Fed Beige book reported signs of an increased pass-through of higher input costs reinforcing signs of intensifying inflation pressures. Decelerating economic growth and higher inflation pressures are the twin enemies of the Fed's goal of price stability and sustainable growth. At this time, further rate hikes look necessary.

## The LGIP

The fed funds rate was raised by 25 bps at the January, March and May FOMC meetings, bringing the rate to 5.00 percent. The Fed is widely expected to raise the rate again by 25 bp at the June 29 FOMC meeting. As has been the case for nearly two years, in anticipation of rising rates the average life of the LGIP portfolio has been kept short in order to be able to reprice to the rising funds rate as quickly as possible.

Accordingly, the net LGIP yield has

## LGIP Advisory Committee

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*continued on page 3*

## From the LGIP Administrator's Desk

By Robbi Stedman



Happy Birthday, LGIP. 2006 marks the 20<sup>th</sup> anniversary of the Local Government Investment Pool. It is hard to believe it has been 20 years already...especially since I was 6 years old when the pool started!

The Local Government Investment Pool was authorized by Chapter 294, Laws of 1986. In part, this legislation states: "The purpose of this chapter is to enable political subdivisions to participate with the state in providing maximum opportunities for the investment of surplus funds consistent with the safety and protection of such funds. The legislature finds and declares that the public interest is found in providing maximum prudent investment of surplus funds, thereby reducing the need for additional taxation. The legislature also recognizes that not all political subdivisions are able to maximize the return on their temporary surplus funds. The legislature therefore provides in this chapter a mechanism whereby political subdivisions may, at their option, utilize the resources of the State Treasurer's Office to maximize the potential of surplus funds while ensuring the safety of public funds."

We thought on this 20th Anniversary that it would be fun to take a look back in history at the beginning of the pool. In July of 1986 we signed up our first participants, including 37 different entities. By comparison, we have around 485 participants today. The pool in its first year experienced immediate and widespread acceptance, ending the first fiscal year with participation by 117 local governments for a value of \$346 million. For another comparison of our growth, we

ended Fiscal Year 2005 with about \$4.5 billion.

The initial administrative fee was 25 bp, and at the end of the first year, the pool offered a rebate of nearly \$94,000. The current fee is 3.5 bp and last year we had a rebate of more than \$1 million. In July 1987, the makeup of the participants was 21 counties, 85 cities, and 11 special purpose districts. Today, all 39 counties, 225 towns/cities, 26 college/universities, and 135 special tax districts use the pool.

Developments through the years have included the development of the LGIP Advisory Committee to provide participant oversight, a quarterly newsletter, an outside independent audit of the LGIP, the development of a CAFR, an extension of the cutoff time for transactions from 9 a.m. until 10 a.m., and the development of the Treasury Management System (TMS) to provide for online reporting and transaction notifications.

We certainly value the partnership we've developed with LGIP participants in providing a safe, liquid investment opportunity for your surplus funds and a competitive return. The LGIP sets a high bar for banks to reach if they want to compete for your funds. We have obviously come a long way in the last 20 years thanks to all of your participation.

## Market summary

*continued from page 2*

steadily increased from 4.23 percent in January to 4.85% in May. LGIP participants should expect the LGIP yields to continue to rise as long as the Fed continues to raise the fed funds rate.

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### **LOCAL Program**

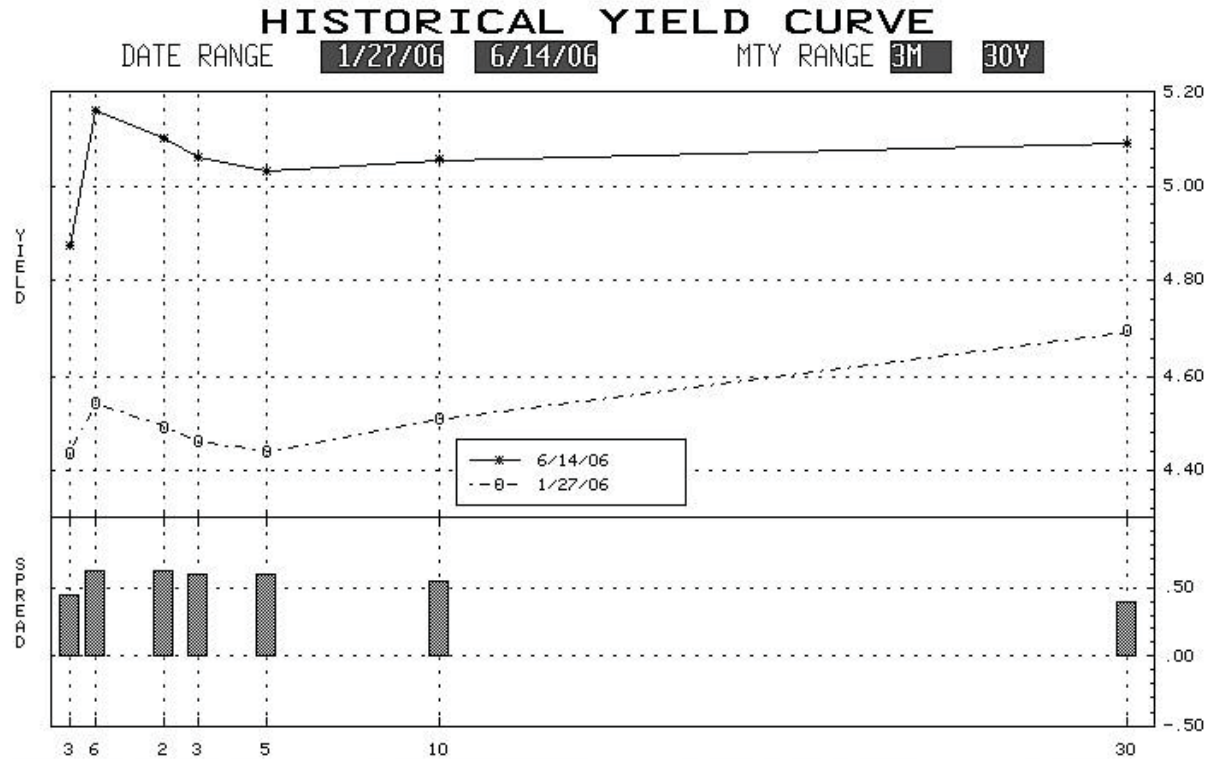
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## LGIP Holiday Schedule for 2006-2007

The Local Government Investment Pool will be closed on the following days:

Monday	May 29	Memorial Day
Tuesday	July 4	Independence Day
Monday	September 4	Labor Day
Monday	October 9	Columbus Day
Friday	November 11	Veteran's Day
Thurs/Fri	November 23-24	Thanksgiving Holiday
Monday	December 25	Christmas
Monday	January 1	New Year's Day

## Statewide Custody Program Update

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### Port of Seattle has flawless conversion

April 1, 2006, marked the beginning of the new statewide custody contract with the Union Bank of California (UBOC). Since their announcement as the new statewide custody provider, UBOC has been actively marketing its services to municipalities in Washington.

The largest conversion in the six-year history of the statewide custody program occurred May 1 when the Port of Seattle joined the program.

According to Craig Kerr, treasury manager for the Port of Seattle, the conversion of more than \$700 million in securities was flawless. In addition to saving a tremendous amount of time compared to conducting the search themselves, the port is saving more than 40 percent on fees, around \$14,000 annually.

So far, six local governments have completed the

conversion, while several others have either begun the process or expressed interest in the program. In addition to the Port of Seattle, the following entities are using the statewide custody program with UBOC: Lynnwood, Maple Valley, Yakima, Jefferson County, and Snohomish County. The total market value under the statewide contract is more than \$900 million.

Entities interested in details about the program can contact Andy Jeremi, UBOC vice president for the Statewide Securities Custody Program, at 415-705-5043 or by email at [andy.jeremi@UBOC.com](mailto:andy.jeremi@UBOC.com). You may also obtain information about the program from OST by visiting our Website at ([www.tre.wa.gov](http://www.tre.wa.gov)) or by contacting Doug Extine at 360-902-9012 or by email at [doug@tre.wa.gov](mailto:doug@tre.wa.gov).

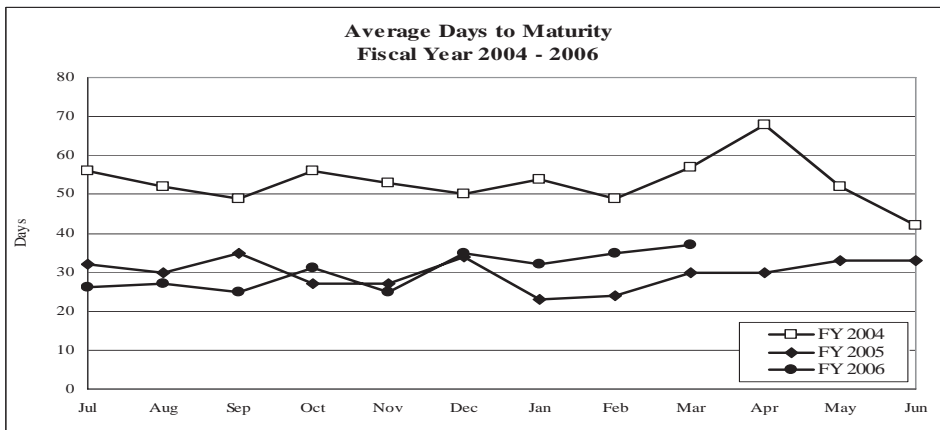
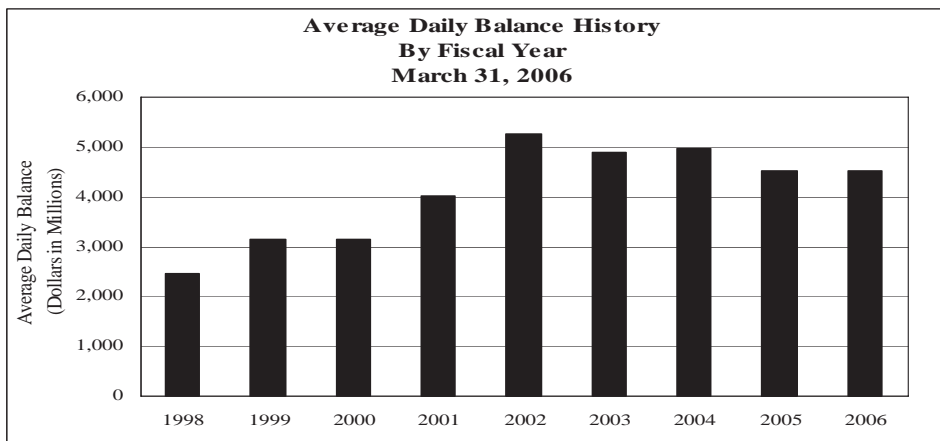
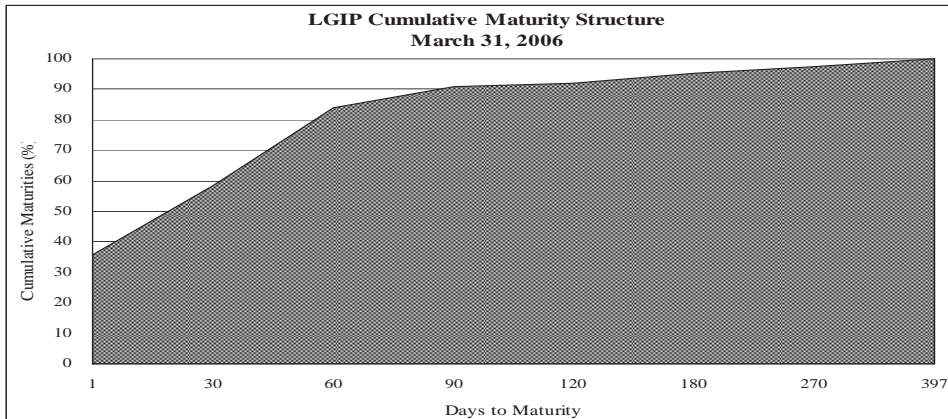
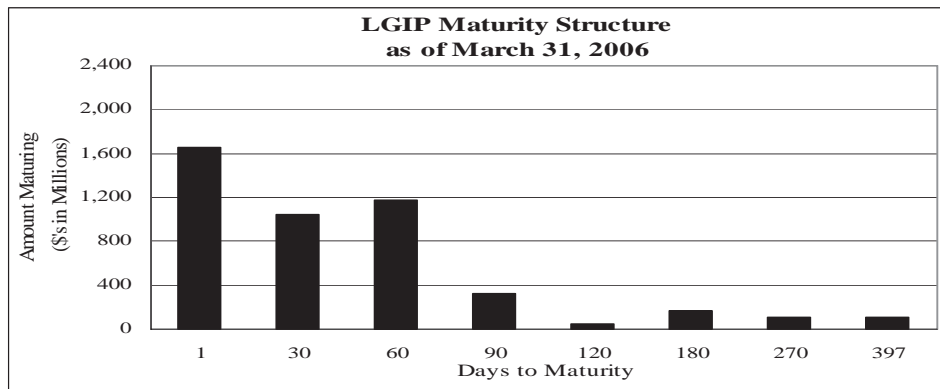
### WFOA Conference 2006: Another strong investment track

Mark your calendars: We have put together another strong investment track for the 2006 WFOA Conference in Tacoma.

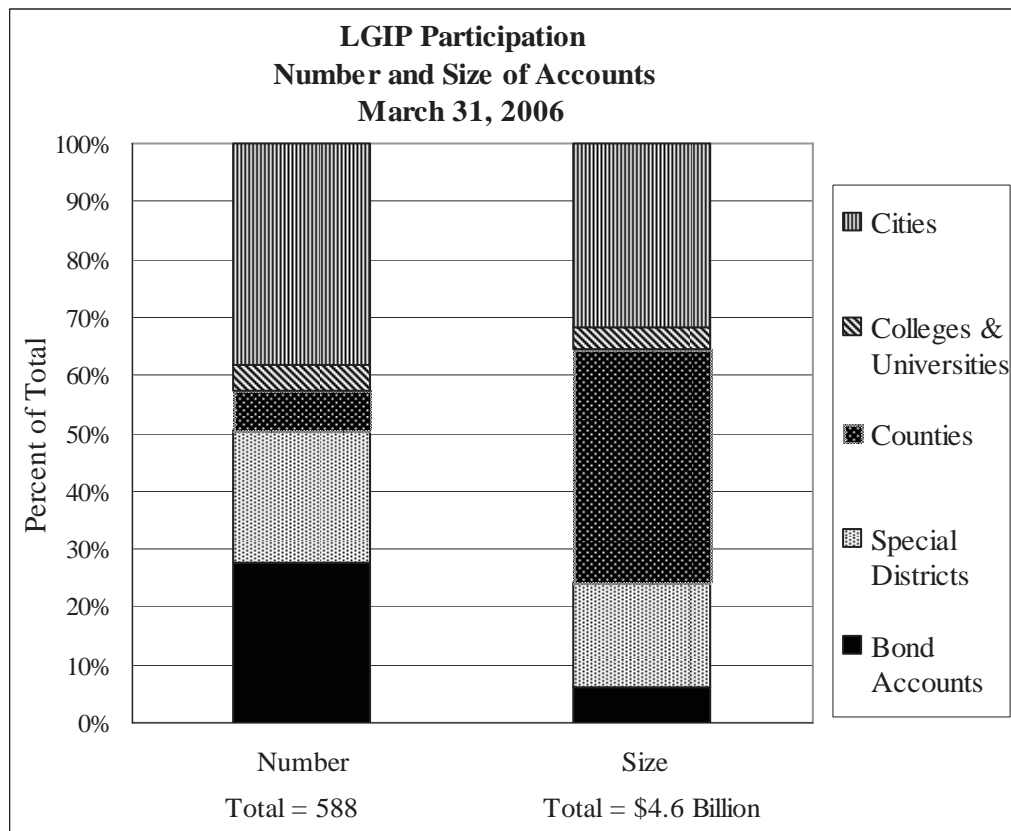
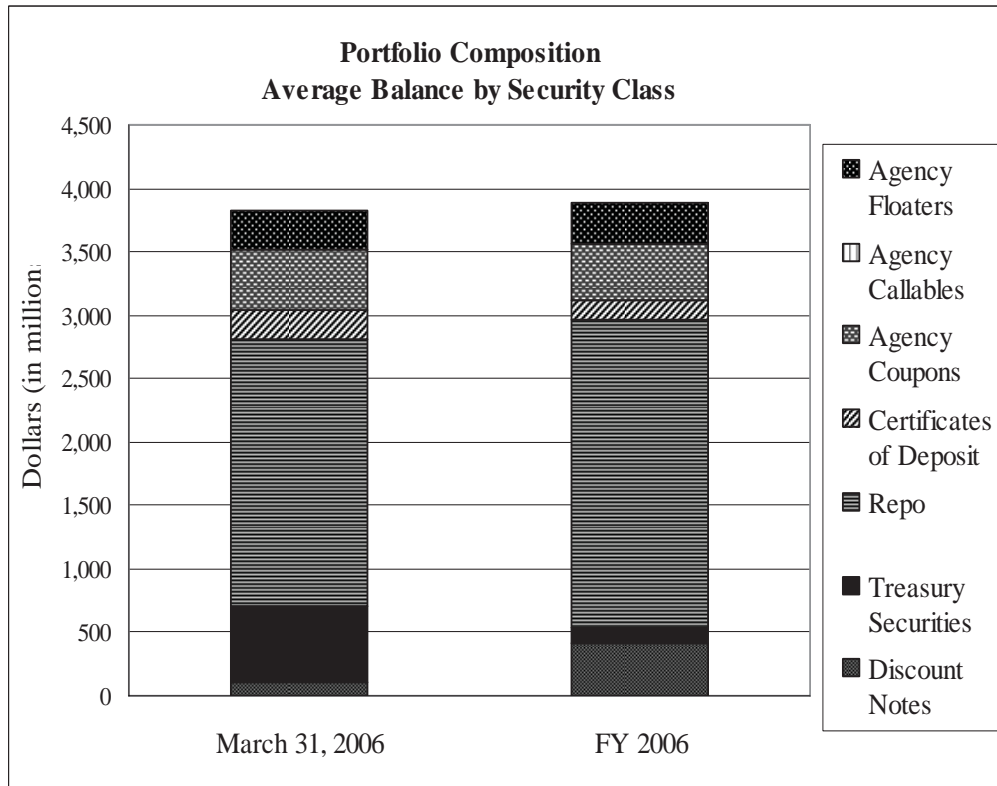
The date of the investment track of classes is Wednesday, Sept. 13. We will start with a basic investment course, followed by a course on best practices for your investment program. Three afternoon courses will cover more advanced investment topics: yield curve trades, evaluating different types of callable securities, and a current look at the US Agency market along with an eye toward future developments.

We have a great stable of speakers, including Margaret Kerins, Greenwich Capital Markets; Deanne Woodring, DA Davidson; Hector Cortez, Bank of America Securities; and Mark Evans, Vining Sparks.

See you there.







## LGIP Advisory Committee: April 7, 2006 meeting highlights

The LGIP Advisory Committee met April 7, 2006, at noon in the House Rules Room, Legislative Building, Olympia, Washington.

State Treasurer Michael J. Murphy welcomed Moon Lee, Lou Nagy, Andi Jeremi, and Aran King, all with the Union Bank of California (UBOC) to the meeting. They gave a presentation to the committee which included a brief overview of UBOC, the services it will provide as the newly selected statewide custody provider, and a status report. They reported that in addition to some of the past participants in the statewide custody program electing to use UBOC, the Port of Seattle has chosen to participate in the program and by doing so will achieve annual savings of over \$14,000. Discussion followed. Treasurer Murphy excused UBOC from the meeting.

Treasurer Murphy welcomed Doug Streeter of Grays Harbor County PUD as a new member of the Advisory Committee. Doug replaced Mark Wyman as the Washington PUD Association's representative on the committee.

Doug Extine gave an update on the performance of the LGIP. The net rates for the pool for January, February and March were 4.23, 4.42 and 4.5 percent, respectively. The fed funds rate has been increased by 25 basis points (bp) at each FOMC meeting, to 4.5 percent in January and 4.75 percent in March.

Extine spoke about the strategy for managing the LGIP portfolio. Currently, the portfolio has an average life of 37 days. The anticipated gross rate for April is 4.67 percent. As has been the case for the past several months, the strategy is to keep short in anticipation of continued fed fund increases. Discussion followed.

Robbi Stedman distributed a handout to committee members describing LGIP month-end balance activity for FY 2004, 2005 and 2006. She explained that balances are comparable to what they were in FY 04 and 05. Another handout portrayed the daily balances from the third quarter of 2006.

The balance in the pool is currently \$4.5 billion. Discussion followed.

Extine reviewed the estimated FY 2006 budget and provided a handout to committee members. Compared to the original estimate, fees collected have been higher and expenses slightly lower. Accordingly, the current estimate of the rebate for fiscal year 2006 has been increased by \$230,000 to \$1.052 million. Discussion followed regarding the possibility of lowering the fees from the current 3.5 bp. The consensus of the committee was that because fees collected in excess of expenses were rebated to LGIP participants, there was no need to lower the fees.

Stedman gave an update on the movement to Bank of America's new system, the internet-based BA Direct. She reported that the LGIP is now operating completely on BA Direct. Some advantageous features of Direct were mentioned.

Extine brought the attention of the committee to the LGIP bylaws in response to a question from a member at the January meeting about the necessity of quarterly meetings. Members were asked to review the current by-laws to see if they had any suggested changes. Discussion followed, and it was decided that no changes were required.

The next meeting will be scheduled in July 2006. When that date has been selected, committee members will be notified.

The meeting was adjourned at 2:15 p.m.



**Washington State Local Government Investment Pool**  
**Position and Compliance Report**  
**as of 3/31/2006**  
(Settlement Date Basis, In Thousands)

<b>LGIP Portfolio Holdings</b>	<b>Amortized Cost</b>	<b>Percentage of Portfolio</b>
Agency Bullets	\$ 480,730	10.38
Agency Discount Notes	113,533	2.45
Agency Floating Rate Notes	313,975	6.78
Agency Variable Rate Notes	114,983	2.48
Certificate of Deposit	222,500	4.80
Interest Bearing Bank Deposits	339,394	7.33
Repurchase Agreements	2,308,000	49.82
U.S. Treasury Bills	739,906	15.97
U.S. Treasury Coupons	0	0.00
	<u>\$ 4,633,021</u>	<u>100.00</u>

**Securities Lending Holdings**

Repurchase Agreements	346,431
	<u>\$ 346,431</u>

**Total Investments &  
Certificates of Deposit**

\$ 4,979,452

**Policy Limitations**

*The policy limitations include investment of cash collateral by a securities lending agent calculated as percentages of the portfolio holdings Total Excluding Securities Lending.\**

**Size Limitations**

	<b>Holdings</b>	<b>Percentage of Portfolio</b>	<b>Policy Limitations Percentage</b>
Floating Rate and Variable Rate	\$ 428,958	9.26	30%
Variable Rate Notes > 397 Days	0	0.00	10%
Other Structured Notes	0	0.00	10%
Term Repo > 30 Days	400,000	8.63	30%
Certificate of Deposit	222,500	4.80	10%
Bankers' Acceptances	0	0.00	20%
Commercial Paper	0	0.00	25%
Reverse Repo	0	0.00	30%
Security Lending + Reverse Repo	344,037	7.43	30%

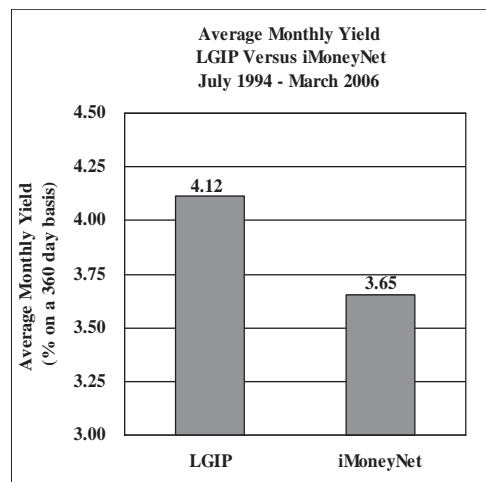
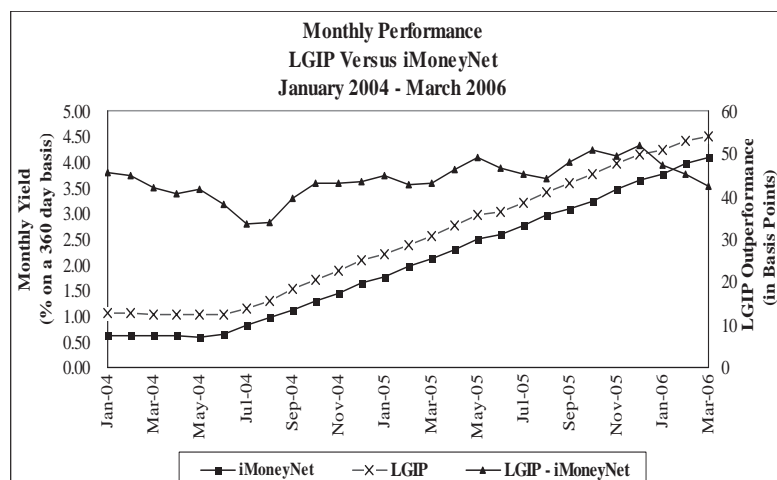
**Maturity Limitations**

	<b>Currently</b>	<b>Policy Limitations</b>
Weighted Average Maturity	37day(s)	90 day(s)
Maximum Maturity		
Bullet Maturities	321 day(s)	397 day(s)
Floating Rate and Variable Rate Notes	474 day(s)	762 day(s)
Repos	34 day(s)	180 day(s)
Reverse Repos	0 day(s)	90 day(s)

**Repo Limits Per Dealer**

*continued on page 10*

## LGIP Performance Comparison iMoneyNet, Inc.<sup>1</sup> versus Local Government Investment Pool



The chart on the left shows a monthly comparison from January 2004 through March 2006 and how the LGIP has consistently outperformed the benchmark.

The chart on the right shows an average monthly yield comparison from July 1994 to March 2006. The LGIP net rate of return has outperformed its benchmark during that time period by an average of 46.5 basis points. This translates into the LGIP earning \$192.11 million over what the average comparable private money fund would have generated.

<sup>1</sup> Average Net Rate of Return of Government Only/Institutional Only Money Market Funds, *Money Market Insight*, iMoneyNet, Inc., West borough, MA. This benchmark is comprised of privately managed money market funds similar in composition and investment guidelines to the LGIP.

### *Position and Compliance Report as of 3/31/06 from page 9*

#### Repo Limits Per Dealer

	March 31, 2006	Total Repo Percentage (20% limit)	Term Repo Percentage (10% limit)	Projected Redemptions 3/31/2006	Projected Position 03/31/2006
Banc America Securities	\$ 398,000	8.59%	4.32%	\$ 198,000	\$ 200,000
Bear Stearns & Co.	515,790	11.13%	8.63%	115,790	400,000
Goldman Sachs	86,622	1.87%	0.00%	86,622	0
Greenwich Capital	350,000	7.55%	8.19%	350,000	0
JP Morgan/Chase	94,013	2.03%	0.00%	94,013	0
Merrill Lynch	300,000	6.48%	6.48%	0	300,000
Morgan Stanley Dean Witt	450,007	9.71%	8.63%	50,007	400,000
UBS Warburg	460,000	9.93%	8.74%	460,000	0
<b>Total</b>	<u>\$ 2,654,432</u>			<u>\$ 1,354,432</u>	<u>\$ 1,300,000</u>

# Local Government Investment Pool

## STATEMENT OF NET ASSETS

March 31, 2006

(In Thousands)

### Assets

Investments, at Amortized Cost:

Repurchase Agreements \$ 2,308,000

U.S. Agency Securities 1,023,221

U.S. Treasury Securities 739,906

**Total Excluding Securities Lending** 4,071,127

Securities Lending Investments, at amortized cost:

Repurchase Agreements 346,431

**Total Investments**

**(Settlement Date and Trade Date Basis)** 4,417,558

Interest Bearing Bank Deposits 339,394

Certificates of Deposit 222,500

Cash 86

Interest Receivable 11,573

**Total Other Assets** 573,553

**Total Assets** 4,991,111

### Liabilities

Accrued Expenses 776

Obligations under Securities Lending Agreement 346,431

**Total Liabilities** 347,207

### Net Assets

\$ 4,643,904

Total Amortized Cost - Settlement Date Basis \$ 4,979,452

## QUARTER AT A GLANCE

January 1, 2006 to March 31, 2006

(in Thousands)

Total investment purchases: \$ 30,324,681

Total investment sales: \$ 530,787

Total investment maturities: \$ 29,564,480

Total net income: \$ 48,385

Net of realized gains and losses: \$ 3

Net Portfolio yield (360-day basis):

January 4.2322%

February 4.4223%

March 4.5045%

Average weighted days to maturity: 37 days

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